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No. 475

IN THE

Supreme Court of the United States

OCTOBER TERM, 1932

DAVID BURNET, Commissioner of Internal Revenue,
Petitioner,

v.

S. & L. BUILDING CORPORATION.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR THE RESPONDENT

INDEX

	PAGE
QUESTION PRESENTED	1
STATEMENT	2
Respondent's Computation	2
ARGUMENT	3
CONCLUSION	8
APPENDIX (Statutes)	10

CITATIONS

CASES:

Bowers *v.* New York and Albany Lighterage Co., 273 U. S. 346	6
Central Real Estate Corp. *v.* Commissioner, 47 Fed. (2d) 1036	7
Lucas *v.* Schneider, 47 F. (2d) 1006, certiorari denied, 284 U. S. 622	3
Maryland Casualty Company *v.* United States, 251 U. S. 342	7
Todd, B. B., Inc., 1 B. T. A. 762	7
United States *v.* Kirby Lumber Co., 284 U. S. 1	5

STATUTES:

Section 212 (d), Revenue Act of 1926	2, 4, 6, 8, 10
Section 605 Revenue Act of 1928, amending Section 1108 (a) of the Revenue Act of 1926	10

MISCELLANEOUS:

Treasury Regulations 69, Article 44	3
Treasury Regulations 69, Article 44, as amended January 8, 1929	4

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BRIEF FOR THE RESPONDENT

QUESTION PRESENTED

The question presented by the petitioner is broader than the facts in the instant case warrant.

Correctly stated, the question is, whether the first sentence of the last paragraph of Article 44 of Treasury Regulations 69, as amended, is valid when applied to the facts in this case involving the sales of mortgaged property, where the purchasers assumed the mortgages which were originally given by the seller (respondent) who remains liable thereon, until actual payments are made by the purchasers of the property.

STATEMENT

Petitioner's statement omits the respondent's method of computing profit on the installment plan of the sales of properties, 82nd Street and Broadway and 83rd Street Street and Broadway, respectively, which was approved by the Circuit Court of Appeals.

As to 82nd Street and Broadway property, which was sold in the year 1924, the respondent, pursuant to Section 212 (d) of the Revenue Act of 1926, computed the profits on the installment plan in the following manner:

Total Profit to be Realized		$ 558,676.52
Total Contract Price (Purchase Price)		2,100,000.00
Percentage of total profit ($558,676.52) to total contract price ($2,100,000.00)		26.603643%
Initial Payments:		
Cash	$300,000.00	
Payments on purchase money mortgage	30,000.00	
Payment on December 1, 1924 by purchaser on mortgage assumed	22,000.00	352,500.00
Profit realized in 1924 (26.603643% times initial payment of $352,500.00)		93,644.82

For the year 1925, the purchaser of this property made the following payments on account of the total contract price of $2,100,000.00.

Payments on purchase money mortgage	$ 36,250.00
Payments on mortgage assumed	44,000.00
Total	$ 80,250.00

The respondent computed the realized profit applicable to these payments in 1925, to be $21,349.42 (26.603643% times $80,250.00 equals $21,349.42).

As to the sale in 1925 of 83rd Street and Broadway property, reported on the instalment plan, the respondent by following the above method determined the realized

profit for 1925 applicable to this sale in the following manner:

Total Profit to be Realized		$ 642,967.00
Total Contract Price (Purchase Price)		2,165,000.00
Percentage of total profit to total contract price		29.698244%
Initial payments:		
Cash	$300,000.00	
Payment on purchase money mortgage	2,000.00	
Payment during 1925 on first mortgage assumed	None	
Payment on second mortgage assumed	22,500.00	324,500.00
Profit realized in 1925 (29.698244% times initial payment of $324,500.00)		96,370.80

ARGUMENT

The petitioner states as reasons for granting the writ, that (1) the decision of the Circuit Court of Appeals conflicts in principle with the decision of the Circuit Court of Appeals for the Sixth Circuit in *Lucas* v. *Schneider*, 47 F. (2d) 1006, certiorari denied, 284 U. S. 622; (2) the decision will result in filing of refund claims and the imposition of increased deficiencies as well as raising new issues all of which will present great difficulties of administration; (3) the decision provides a method of computing income on the installment plant which is inconsistent with the general scheme of accounting contemplated by the Revenue Acts.

The Circuit Court of Appeals has considered these arguments of the petitioner and by its decision has clearly rejected these contentions. The decision stated that *Lucas* v. *Schneider* "has no bearing on the situation here,—we need here only decide whether the regulation is a correct interpretation as to the calculation of the return." The Circuit Court of Appeals for the Sixth Circuit was called upon, however, to decide whether the taxpayer had a right to the use of the installment method of reporting income,

and not to determine the correct method by which the total profit is to be returned annually on the installment plan. The petitioner has at all times conceded that the respondent is entitled to report the profit from the sale of these two properties on the installment plan. There is no dispute about this. But the dispute arises, however, as to whether regulations 69, Article 44, as amended, is a correct interpretation of the Statute as to the calculation of the return.

This regulation provides:

> "In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall be included as a part of the 'purchase price' but the amount of the mortgage, to the extent it does not exceed the basis to the vendor of the property sold, shall not be considered as part of the 'initial payments' or of the 'total contract price', as those terms are used in Section 212 (d), in Articles 42 and 45, and in this Article. * * *"

Prior to the amendment of this regulation approved January 8, 1929, after the issuance by the petitioner of the deficiency notice dated February 4, 1928 (R. 11), the regulation read as follows:

> "In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage, or whether the mortgage is assumed by the purchaser, shall not be considered as part of the 'initial payments' or of the 'total contract price' but shall be included as part of the 'purchase price', as those terms are used in Section 212 (d), in Articles 42 and 45, and in this Article. * * *"

The above quoted regulations completely ignore a case such as this, where the seller borrows money and gives his

bond and mortgage securing said loan, upon which he remains liable until it has actually been paid off either by him directly, or for him by the purchaser who assumes this obligation. It is contended by the respondent that the seller is relieved of this mortgage obligation only when payments thereon are made, and to the extent of these payments, the portion of profit applicable thereto, computed on the installment basis provided by law, will be considered income by him when paid.

The petitioner cites the case of *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, to support his contention that the assumption by the purchaser of the mortgage obligation to the extent that it exceeds the basis of the property results in income, for the reason that as between the purchaser and seller, the latter has been relieved of his liability. It is quite apparent that the *United States* v. *Kirby Lumber Co.* case has no bearing on this issue. In that case, the Supreme Court held "that where a corporation purchases and retires its own bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is taxable income for the taxable year." The retirement of an obligation is entirely different than the assumption of an obligation. In effect, the retirement of a bond obligation cancels it forever, while the assumption keeps the obligation alive; the obligor being relieved to the extent that the payments, pursuant thereto, have actually been made.

Furthermore, the regulation is inconsistent when it requires the splitting up of the entire mortgage obligations, considering that part which exceeds the basis of the property, as having been cancelled and consequently taxable income, while the balance of the mortgage obligations it considers as a return of the cost. This treatment of

mortgage obligations is contrary to Section 212 (d) of the Revenue Act of 1926, which grants a privilege of reporting profits on the installment plan. Moreover, the regulation, when applied to this case, violates this section, by requiring respondent to report part of the profits on the installment basis and part on the accrual basis. It requires the respondent to report a greater profit in the year of sale than the law contemplated. On the sale in 1925, of 83rd Street and Broadway property, the petitioner computes the portion of the total profit applicable to this year, at $379,967.00, whereas, according to respondent's computation, the amount should be $96,370.80. The effect of the petitioner's computation is that it creates an unwarranted larger profit to be returned in the year of sale than that authorized by law, thereby depriving him of its advantages. Inasmuch as Section 212 (d) was enacted primarily to benefit the taxpayer, it should be construed liberally in his favor. *Bowers* v. *New York and Albany Lighterage Co.*, 273 U. S. 346. Therefore, the regulation, which excludes a portion of the mortgages assumed from the "total contract price" in arriving at a percentage of profit to be returned on each installment, and includes a portion of the mortgages as part of the "total contract price" where such portion exceeds the base, is inconsistent with the statute, unreasonable, and therefore declared invalid by the Circuit Court of Appeals.

The petitioner's contention, that the decision will result in filing of refund claims and impose increased deficiencies, appears to be no argument for granting a writ of certiorari.

The petitioner's arguments, that the regulation nullified by the decision of the Court below has been consistently upheld by the Board of Tax Appeals; that the statute to which the regulation applies was substantially re-enacted

in the Revenue Act of 1928; that under these circumstances the administrative interpretation of the statute should not be disregarded, are completely answered by the Circuit Court of Appeals, Fifth Circuit, in its decision, *Central Real Estate Corp.* v. *Commissioner,* 47 Fed. (2d) 1036.

The respondent's method of computing income on the installment plan presents no difficulties of administration. On the contrary, it establishes an equitable uniform basis which may be followed by all taxpayers who elect to return the profit from the sale of property on the installment plan. The taxpayers' books, if properly maintained along the lines of recognized accounting procedure, should reflect, according to either the respondent's or petitioner's method of reporting profit on the installment plan, appropriate accounts, including accounts variously designated as "Deferred Profits from Sale of Properties on Installment Plan", or Reserve for Unrealized Profits from Sale of Properties on Installment Plan". This account at all times reflects the amount of profit not as yet realized. Appropriate journal entries are made at the end of each calendar or fiscal year transferring from this account the realized profit computed in accordance with respondent's method. Aside from the method of bookkeeping employed by a taxpayer, it has been held that income is a "matter of fact—not of bookkeeping". *Maryland Casualty Company* v. *United States,* 251 U. S. 342; *B. B. Todd, Inc.,* 1 B. T. A. 762.

Contrary to the claims of the petitioner, that the decision of the Circuit Court of Appeals will create confusion in the administration of Federal tax laws, it is contended by the respondent that this decision will clarify the last paragraph of Article 44 of the Regulations 69 as amended, by eliminating the inconsistencies that now exist therein.

This decision will provide a uniform method of applying Section 212 (d) of the Revenue Act of 1926, as well as the subsequent Revenue Acts. This regulation, which has been declared by the Circuit Court of Appeals to be invalid when applied to the facts in this case, does not carry out the intent of Congress to relieve taxpayers of the burden of paying taxes on profits not yet realized.

It is significant to note that under present adverse conditions, many foreclosures have taken place on real estate, resulting in considerable losses to taxpayers who were called upon to make good the deficiencies arising out of their liability on their bond and mortgages, even though they were assumed by the purchasers of their properties. Consequently, the inconsistency of the regulations is more real than apparent. The decision of the Circuit Court of Appeals takes cognizance of this liability by considering the existing mortgages on the property as a part of the "total contract price".

It would, therefore, be a simple matter for the petitioner to conform the regulations to this decision by amending the last sentence of Article 44 of Regulations 69 and subsequent regulations. Section 605 (Revenue Act of 1928) amending Section 1108 (a) of the Revenue Act of 1926, provides for the amendment of regulations without retroactive effect.

CONCLUSION

The application for writ of certiorari should be denied for the reasons that the petitioner failed to prove in his petition that the Circuit Court of Appeals has erred in its decision; that no conflict exists between this decision and other Circuit Court of Appeals decisions; that no confusion will exist in the administration of Section 212 (d) of the Revenue Act of 1926 and subsequent Revenue Acts,

if the petitioner will properly amend the applicable regulations to conform to this decision which correctly interprets Section 212 (d) of the Revenue Act of 1926.

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October, 1932.

APPENDIX

STATUTES.

Revenue Act of 1926.

Sec. 212 (d). Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the payment is completed, bears to the total contract price. In the case (1) of a casual sale or other casual disposition of personal property for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed one-fourth of the purchase price, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this subdivision. As used in this subdivision the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made. (U. S. C. App., Title 26, Sec. 953.)

Revenue Act of 1928.

Sec. 605. Section 1108 (a) of the Revenue Act of 1926 is amended to read as follows:

In case a regulation or Treasury decision relating to the internal-revenue laws is amended by a subsequent regulation or Treasury decision, made by the Secretary, or by the Commissioner with the approval of the Secretary, such subsequent regulation or Treasury decision may, with the approval of the Secretary, be applied without retroactive effect.